Nos. 12535-12536

United States

Court of Appeals

for the Ninth Circuit

LOUIS RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

and

CATHERINE RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

Reply Brief of Petitioners

On Petitions To Review Decisions of The Tax Court of the United States

INDEX

CITATIONS

CITATIONS

Nos. 12535-12536

United States
Court of Appeals
for the Ninth Circut-

LOUIS RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

and

CATHERINE RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

Reply Brief of Petitioners

On Petitions To Review Decisions of The Tax Court of the United States

PRELIMINARY STATEMENT

The petitioners filed their brief in these petitions for review on September 6, 1950, and the brief of the respondent was received by the petitioners' attorney on October 6, 1950. This reply brief is therefore due to be filed on or before October 16, 1950.

ARGUMENT

The argument for the respondent correctly states (Br. 7) "that the fundamental question presented on these appeals is whether the gains from the sales here involved are taxable as ordinary income, * * * or whether such gains should be taxed as capital gains under section 117(j) of the Internal Revenue Code", but it pointedly avoids getting down to cases and principles pertaining to the construction and application of that section.

The petitioners have argued for a recognition of a primary dichotomy in the definition of the coverage of section 117 (j) by section 117 (j) (1) between "property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months", and all of the other classes of income, three in number, which are excluded from the definition of "capital assets" in section 117 (a) (1).

The respondent in his arguments assumes, without any explanation of his assumption, that no such

dichotomy exists and that property sold may be at one and the same time both property used in the trade or business and property held primarily for sale to customers in the course of the taxpayer's business. It is important to note here that he has not always so held with respect to the definition in section 117 (j) (1).

The dichotomy in that definition was clearly recognized in the respondent's first interpretation of section 117 (j) in his addition to Regulations 103 (Title 26, Federal Code of Regulations, Part 19) of Sec. 19. 117-7 by Par. 11, T. D. 5217, C. B. 1943, pp. 314, 327, approved January 19, 1943, and in the amendment of Sec. 19.117-1 of those Regulations by Par. 5(A) of that Treasury Decision. The corresponding sections of Regulations 111 (Title 26, Federal Code of Regulations, Part 29) were in substantially the same words as used in T. D. 5217 when those Regulations were approved October 26, 1943, and published two days later. It was not until the issuing of T. D. 5394, C. B. 1944, p. 274, approved July 27, 1944, after these petitioners had filed their 1943 returns, that the respondent interpreted section 117 (j) (1), I. R. C., to deny the dichotomy which he had previously recognized by including in the first sentence of Sec. 29.117-7 the clause:

> "provided that such property is not of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business".

Compare the copy of the amended provisions in the appendix of the respondent's brief, p. 17.

If we assume that this amendment of Sec. 29.117-7 (Sec. 19.117-7, Regulation 103, has never been similarly amended), which was a retroactive interpretation of section 117 (j) (1), I. R. C., was made on consideration of the clause in the definition in that section of the code reading: "which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business", it is submitted that the construction of that clause as a *proviso* affecting the first and principal part of the definition preceding it, with a strong implication that there might have been intended by the Congress some possibility of property being at the same time depreciable property or real estate used in the taxpayer's business and property in one of the two classes designated under (A) and (B) of the quoted clause, is not supported by the language used in the statute nor by its legislative history. As to the language itself, the words are not those of a *proviso,* which, had the Congress so intended them, were abundantly familiar to draftsmen of revenue laws, which are replete with them, and easy to state in positive form.

As to the legislative history of the section in question, the Revenue Bill of 1942 as passed by the House of Representatives had in it independent amend-

ments of the capital gains provisions relating (1) to the sale of improved real estate and (2) to gains and losses from involuntary conversions and on sales or exchanges of depreciable property used in trade or business, which amendments are explained in items 21 and 25 of the Ways and Means Committee's summary of technical and administrative amendments to the income tax chapter of the Code in its Report, No. 2333, Seventy-seventh Congress, First Session. These items appear in the Bureau of Internal Revenue reprint of the report at pp. 414 and 415, C. B. 1942-2. Consideration of these amendments by the Senate Finance Committee resulted in their coalescence into the group of amendments of section 117 found in section 151 of the Revenue Act of 1942. The general explanation of these amendments in that Committee's report, No. 1631, Seventy-seventh Congress, Second Session, found in the Bureau reprint at p. 525, C. B. 1942-2, is as follows:

> "(2) Under the House bill losses from the sale of real property and buildings were treated as capital losses, even though the property was used in the trade or business. Your committee has changed this rule by taking buildings and real estate used in the trade or business of the taxpayer out of the definition of capital assets, and applying to them the same rule which the House bill applies to gains and losses from involuntary conversions from the sale or exchange of certain depreciable property. If the total gains exceed the losses, such gains will be considered as gains from the sale or exchange of capital assets held for more than six months.

> If the gains do not exceed the losses, such losses will be treated as ordinary gains and ordinary losses instead of capital gains and capital losses. It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant and equipment at a loss.
>
> The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation and real property held for more than six months *which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.*
>
> If a newspaper purchased the plant of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in a trade or business within the meaning of this section." (Italics supplied.)

Attention is directed to the italicized part of this explanation using the words of the clause, the construction of which we are here considering, not having been separated or distinguished from the part of the definition preceding it by so much as a comma to set it off as other than a simple modifier of what went before. Neither in this explanation nor in the detailed discussion of the technical provisions of section 153 of the Bill (which became section 151 of the Act), on p. 594, C. B. 1942-2, is

there anything showing any intent other than one to make clear, in an abundance of caution, that the provisions of sub-section (j) were to apply only to the two classes of property already excluded from the definition of capital assets, section 117 (a) (1), as described in the principal part of the definition in section 117 (j) (1), and not to the two other classes of property which had been likewise excluded from the definition of capital assets.

In the discussion in the 1950 Supplement to Mertens, Law of Federal Income Taxation, Sec. 22.110, p. 258, of the amendments in the Revenue Act of 1942 by which section 117 (j) was added to the income tax law, the clause quoted above is construed as merely modifying the phrase "real estate used in the trade or business". That construction is more certainly in accord with the rules of English syntax and sound principles of statutory construction than the *proviso* construction in Sec. 29. 117-7 as amended by T. D. 5394, *supra.*

Although T. D. 5394 is stated in its opening sentence to have been issued "in order to conform Regulations 111 * * * to sections 101 and 127 of the Revenue Act of 1943, enacted February 23, 1944", sections 101 and 127 of that Act made no change whatever in the clause of section 117 (j) (1) here under consideration. There must therefore have been some other motive for the insertion by that Treasury Decision of the *proviso* interpretation of the subject clause. The timing of this change, more than 18 months after the first interpretative regulation by T. D. 5217,

C. B. 1943, p. 314, adding Sec. 19.117-7 to Regulations 103, and the confirmation of that interpretation in the original Sec. 29. 117-7 of Regulations 111 only eight months before the change was made, strongly indicates that it may have been motivated more by consideration of the effect of the respondent's victory in the case of *Fackler v. Commissioner of Internal Revenue,* 133 F.2d 509 (C. C. A. 6, Feb. 4, 1943) on cases such as the instant one arising after the amendments to section 117 in the Revenue Act of 1942 to make the rule of that case generally more beneficial to taxpayers than to the Government than it was by any doubts of the prior non-argumentative construction having been made according to pertinent and valid rules of statutory construction.

It is too well established to admit of argument that the respondent cannot validly make an arbitrary or unreasonable regulation, or one that repeals or enlarges the scope of a statute. The respondent appears to have tried to enlarge the scope of the definition of section 117 (j) (1) by his amendment of Sec. 29.117-7, Regulations 111. As was stated by the Supreme Court in *Manhattan General Equipment Co* v. *Commissioner of Internal Revenue,* 297 U. S. 129 (1936), 80 L. Ed. 528, 56 S. Ct. 397:

> "The power of an administrative officer or board to administer a Federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress *as expressed by the statute.* A regulation

> which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity." (Italics supplied.)

Since the amendment in question enlarged the scope of the definition in section 117(j) (1) "out of harmony with the statute," it "is a mere nullity."

Both the opinion of Judge Hill in the report of The Tax Court and the respondent's argument in his brief have emphasized the presumption of correctness of the respondent's determination of tax liability and the burden on the petitioners to overcome that presumption. It is submitted that the presumption of correctness relates primarily to facts and not to the respondent's interpretation of the law except in those instances where the statute particularly provides for administrative details to be handled according to "regulations prescribed by the Commissioner with the approval of the Secretary," as in section 23 (o), I. R. C. When it is shown, as we have shown above, that the respondent has based his determination on an improper construction of the statute and that The Tax Court has adopted the same construction, the facts of record have finally to be judged according to the law as correctly construed.

As has been shown in the petitioners' opening brief, pp. 17 to 20, the finding as ultimate fact that the dwellings in question in this proceeding were held primarily for sale to customers could be justified in The Tax Court's opinion only on the bases of assumptions and hypotheses which provided a frail founda-

tion for his findings, even if the correctness of that Court's and the respondent's construction of the law were conceded. However, under a proper and valid construction of the statute, the stipulation of facts furnished full proof of the error of the respondent's determination and the Tax Court's finding is wholly erroneous because it is quite immaterial to the real criteria of classification for the purposes of section 117 (j).

Although the Court of Appeals for the Eighth Circuit in its opinion in *Albright* v. *United States,* 173 F. 2d 339, did not adopt a dichotomic construction of the definition in section 117 (j) (1), I. R. C., as contended by the petitioners in the instant case, it did arrive at a result consistent with such construction by finding as a fact that dairy and breeding herd sales of cows and hogs were not "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" despite the evidence and common knowledge that such sales were normal and regular events in businesses such as Mr. Albright's. In so doing it was in effect following the lines of cases in the Tax Court under section 117 (j) and the amendment of the definition of capital assets in section 117 (a) (1) of the Revenue Act of 1938 cited under Proposition 11 of the petitioners' opening brief (pp. 10-13) which made the depreciable character of the property sold the touchstone of the classification of a sale as being within or without the definition of property subject to special treatment by one definition or the other.

In this connection it is of some significance to note that Judge Hill in a case decided by him contemporaneously with this one, *A. Benetti Novelty Co.,* 13 T. C. 1072, promulgated December 22, 1949, had no difficulty in deciding, exactly in line with the dichotomic interpretation of the definition in section 117 (j) (1) if not specifically on such a basis that the sales by the Novelty Company of slot machines and juke boxes to agencies of the Army and Navy were within the coverage of section 117 (j) despite the stipulated fact that it "was requested (the exact time was not disclosed) by various agencies of the Army and Navy to acquire for them as many of these machines as possible" and that it "complied with these requests, sending its agents through Nevada and the adjoining states and buying any and all machines offered for sale". The inconsistency of his opinion in that case, which he supported with quotations from *Nelson A. Farry,* 13 T. C. 8, a case comparable in its facts to the instant one, and from the *Albright* case, *supra,* with his opinion in this case (R. 26-41) is all too apparent on comparison of the two opinions. The only reasonable explanation of such inconsistency is that the author of the two opinions valued the patriotic effort of the Novelty Company in supplying the military components of the war effort with amusement and gambling devices more highly than he did the patriotic effort of Mr. Rubino in supplying the civilian components of that effort with housing. In view of this inconsistency, it is submitted that the petitioners' criticisms of Judge Hill's opinion on

the basis of prejudgment and prejudice (pp. 16 to 21 of their opening brief) are amply justified despite the respondent's question begging submission (p. 14 of his brief) "that there is no adequate basis of such criticism".

The respondent's argument (p. 13 of his brief) that there is no inconsistency between the allowance of depreciation on property and its classification as being held *primarily* for sales to customers in the ordinary course of a taxpayer's business is patently fallacious. It simply begs the question when it says (p. 13) that "we see nothing in Sec. 29. 23(1) -2 of Treasury Regulations 111, or any of the other authorities cited by the taxpayer which is at variance with that view". In the *Fackler* case, *supra,* cited by him it was precisely the integration of the depreciation provisions of section 23 (1) with the definition of capital assets in section 117 (a) (1) which enabled the respondent to win the decision over Mr. Fackler. The case of *Harvey* v. *Commissioner of Internal Revenue,* 171 F. 2d 952 (C. A. 9, 1949). also cited by the respondent, turned in the respondent's favor on the same point, p. 954, in support of which this Court cited the *Fackler* opinion. The case of *A. L. Carter Co. et al.* v. *Commissioner of Internal Revenue,* 143 F. 2d 296 (C. A. 5, 1944) simply decided that allowable depreciation, whether previously deducted by the taxpayer or not, had to be deducted from the cost of rented dwellings sold by the taxpayer in 1938 and 1939. There was no question raised as to the classification of the gains as capital assets since under

the definition of such assets as amended by the Revenue Act of 1938 depreciable assets were excluded from the definition. It is not apparent why the case of *Charles H. Black, Sr.,* 45 B. T. A. 204 (1941) is cited by the respondent in this connection inasmuch as the case makes no reference whatever to the depreciable character of the building there involved. It would seem that if the respondent's attorney in that case had brought up the relationship of depreciation allowances to business use as furnishing a basis for classification of the property in question as a capital asset used in the taxpayer's business, he might have won it instead of losing it.

The reference to Bulletin "F", Income Tax Depreciation and Obsolescence (Revised January 1942), p. 85 (Br. p. 14) is not precise as to the matter to which the respondent wishes the Court's attention directed. If he refers to the paragraph headed *"Rented Property"*, the statement therein, that depreciation of real property rented for residential property is deductible even though the operation of such property is not the taxpayer's principal trade or business, does not appear to be significant of any point involved in this proceeding. If, however, he refers the paragraph headed "Buildings not occupied", it is suggested that the rule there stated is obsolete in relation to the precise conditions for the allowance of depreciation set forth in Sec. 29.23 (1)-2, Regulations 111 quoted on p. 15 of the petitioners' opening brief, and appears in the Bulletin as revised in 1942 by reason of careless editing of matter copied from the 1931 edition of

Bulletin "F", where the same paragraph is printed on page 18. It apparently had its origin in I. T. 1342, C. B. I-1 (1922), p. 169, in which it is stated that depreciation is allowable on buildings held for sale by a taxpayer in the business of constructing and repairing buildings for sale which are not otherwise put to business use. That ruling, seemingly buried and forgotten in the 28 years since it was issued, must be put down as a product of the salad days of the Income Tax Unit when offhand rulings without much legal cogitation (now mostly overruled) were fairly common. I. T. 1342 was overruled in effect by the opinion in the case of *Robert H. Montgomery,* 37 B. T. A. 232 (1938).

CONCLUSION

In view of the demonstration in the foregoing argument of the inadequacy of the respondent's brief to show that the petitioners' contentions in this proceeding are valid objections to the findings of The Tax Court complained of in the petitions for review, it follows that the petitioners should be granted the relief prayed for in their petitions.

Respectfully,

WAREHAM C. SEAMAN,
Attorney for Petitioners.